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Temple Secrets

Last October, Simon and Schuster published a new book about the Federal Reserve System entitled *Secrets of the Temple* by William Greider. The book received extensive coverage in the press and has been a best-seller in the nonfiction category for several months.

The book's sub-title, *How the Federal Reserve Runs the Country,* suggests that the Federal Reserve is a powerful influence in our nation's economy. A major conclusion of the book is that this influence generally has been harmful, especially during the last ten years when the Federal Reserve has focused on inflation as a major concern of policy. Greider argues that although the Fed has been successful in bringing down inflation, the costs of doing so have been extremely high compared to the benefits of stable prices, which have been oversold. Most economists, however, would beg to differ.

The Volcker years

Secrets of the Temple is an account of the Volcker years at the Federal Reserve, beginning with Paul Volcker's appointment as Chairman of the Board of Governors by President Carter in August 1979 and ending with the succession of Chairman Greenspan eight years later. Mr. Volcker is criticized in the book for espousing stable money growth as essential to a healthy economy. In fact, Greider argues, a vigorously expanding economy is inconsistent with a monetary policy that emphasizes stable money. The closing pages, written on the eve of the book's publication, describe last October's stock market crash as a "single illuminating moment" in which the orthodox faith in stable money was shown to be an illusion.

Throughout the book, Greider emphasizes the effects of the Federal Reserve's actions on the distribution of income and wealth in our society between those who own financial wealth and those who do not. He argues that the debate between stable money and inflation really is a debate over which group will reap the larger share of the rewards from economic growth. Greider views the events of the last ten years as another historical episode in the continuing conflict between these opposing groups.

The effects of inflation

The early chapters of the book describe the events leading up to the Federal Reserve's adoption of a new, reserves-based operating procedure in October 1979. The book argues that the rising inflation of the late 1970s chiefly hurt the small minority of the population who owned financial assets, and that inflation actually improved the position of many Americans, perhaps even the majority of them. Middle-income homeowners were the big winners from inflation. And the poor and the elderly, he argues, largely were protected from rising prices because social security and other benefit programs were indexed to the inflation rate.

Although Greider recognizes that rising prices frightened and angered almost everyone, he argues that it was financial markets that clamored for a change in policy. Investors, he says, "were in revolt" and "demanded emphatically that the government do something to stop inflation." Thus, the change in Fed policy is characterized as the response of the Federal Reserve to the owners of financial wealth, whom Greider regards as the Fed's major constituency.

Money as a policy target

The book provides a thorough and accurate description of the way the Federal Reserve's Trading Desk alters the supply of bank reserves and thus affects both the level of short-term interest rates and the growth of the money supply. Mr. Greider explains the trade-off between a policy strategy that focuses on controlling short-term interest rates versus one that emphasizes money growth. He describes the debate within the Board of Governors in 1979 and 1980 over the Chairman's plan to tackle inflation by controlling money growth more closely and thus allowing wider fluctuations in interest rates. Greider reports that Governor Henry Wallich, who was considered a "hawk" on inflation, argued strongly against the new approach, which he described as "a pact with the devil." "Sometimes you have to deal with the devil," was Chairman Volcker's reported reply.

Greider explains the theory underlying the Fed's new, more monetarist approach, but argues that Chairman Volcker adopted the money-based procedure mainly for tactical reasons, and not because he accepted this theory. According to Greider, Volcker did not believe that the FOMC would be willing to vote explicitly for the substantial increase in interest rates that would be needed to bring inflation under control. But a procedure that allowed the Fed to attribute high interest rates to "market forces" would diminish political pressures on the Federal Reserve, and make FOMC members more willing to go along. Nonetheless, Greider admits that the new procedure also was designed to "jolt" the financial markets and convince them of the System's resolve to bring inflation under control.

Federal Reserve "temple"

One of the recurring themes in Greider's book is that the Federal Reserve System is not part of the elected government in Washington. He describes the Federal Reserve as a "temple" where "priests" operate in secret, largely insulated from public pressures, and carry on activities that are a mystery to most citizens. Thus, he argues that the policy to reduce inflation not only caused undue pain to large numbers of Americans, but also was imposed by an agency that was not accountable to their elected representatives. Instead, the Federal Reserve's actions mainly reflected the interests of the owners of financial capital.

Greider also faults the Federal Reserve for pursuing a monetary policy that pulled in the opposite direction of fiscal policy during this period. Specifically, Greider argues that the disinflationary monetary policy was at odds with the expansionary fiscal policy favored by the Congress and the President. The book implies that the System thwarted the public's will in this period, and failed to make clear that its anti-inflation policy would cause sharply slower economic growth.

Fed should foster moderate inflation

In Greider's view, then, the disinflationary monetary policies followed during the Volcker years not only redistributed wealth in an undesirable direction, but also hurt the overall performance of the economy. Greider suggests that rising prices, in fact, boost the overall performance of the economy, in contrast to the orthodox view. In the final pages of his book, for example, he argues that easy money and rising prices excite the "animal spirits" of businessmen, giving them the prospect of expanded profits that encourage them to plunge forward with new ventures: "the 'reckless booming anarchy' that fosters great achievements."

He suggests that the periods in U.S. history in which stable money growth has been emphasized have been periods of slow economic growth, whereas those in which stable money has been de-emphasized have been periods of boom. The Federal Reserve, he concludes, should abandon its concern with "sound money" and seek to foster moderate inflation, because this will redistribute wealth in a "positive" direction and also stimulate economic growth.

An economist's view

Most economists would disagree with Mr. Greider's contentions that stable money thwarts vigorous economic expansion and that economic growth can be stimulated by an easy money policy and moderate inflation. Although more rapid money growth at first may produce lower interest rates, this effect is only temporary. When inflation is anticipated, interest rates generally rise, leaving the real, or inflation-adjusted, cost of borrowing unaffected by the inflation. It is the level of real interest rates that ultimately determines the pace of capital accumulation and economic growth.

A second reason for doubting that inflation would lead to faster economic progress is that inflation tends to make the economy less efficient. Since some prices rise more than others, individual households and businesses find it more difficult to interpret how any single price change affects their own situations. As a result, inflation may make for bad decisions that inhibit economic growth. For example, a manufacturing firm that finds it can sell its product at a higher price may conclude that demand for its product has increased and hence decide to increase production. But if this price increase actually reflected a general rise in prices, the decision to commit more resources to production will turn out to be a mistake, and the firm will find that its costs increase by as much as the increase in its sales.

Greider's argument that inflation redistributes income and wealth away from owners of capital and financial assets into the hands of wage-earners also is suspect. Although the inflation of the 1970s apparently was associated with a redistribution of wealth from capital to labor and from lenders to borrowers, most economists argue that this occurred because people did not anticipate the rise in prices and therefore did not factor it into their contracts.

A similar redistribution of wealth likely would not occur if people were to know that moderate inflation was an official goal of Federal Reserve policy. Rather, such a policy would cause interest rates to rise since lenders would demand higher returns to offset rising prices. Indeed, the experience with inflation over the last twenty years has made the public much more sensitive to the effects of rising prices. As a result, the response to faster inflation probably would be a good bit quicker now than it was in the past.

Concern for sound money

The book provides a good description of the mechanics of monetary policy and the techniques used to control monetary growth. The suggestion that the Federal Reserve's experiment with monetary targeting after 1979 was mainly a tactical device, although not unique to Mr. Greider, probably does contain an important grain of truth. However, there also were sound *economic* reasons for targeting a monetary aggregate, since there is a substantial body of evidence that prices and money tend to move together. This historical link between money growth and inflation has weakened in more recent years but was still quite strong in the early eighties.

Because the relation between the stock of money and the growth of aggregate demand has become less reliable in recent years, the Federal Reserve has de-emphasized the aggregates as targets for policy. A number of observers have argued that the conduct of monetary policy has become more difficult precisely because the Federal Reserve currently lacks a reliable intermediate target. Thus, this change shows that monetary targets had more than tactical significance for the System.

The facts do not support Greider's suggestion that the Administration and the Federal Reserve were working at cross-purposes during the early 1980s. It is clear that the Administration strongly favored bringing down inflation, though it hoped that this could be done without a slowdown in economic growth.

Finally, there is a basic inconsistency in Greider's view that the Federal Reserve mainly responds to the interests of the owners of financial capital, who are hurt by rising prices and so demand stable money. This view cannot explain why the System permitted a rise in the rate of inflation during the 1970s that seriously harmed the holders of financial assets in the first place.

In point of fact, the uncertainties and inequities caused by inflation hurt not only participants in financial markets, but others as well. Those who are smart enough (or lucky enough!) to forecast inflation correctly frequently benefit at the expense of those who guess wrong. It is because the damaging effects of inflation extend beyond financial markets and often are distributed in a rather random way that the Federal Reserve demonstrates a continuing concern for sound money.

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